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IRS will not waiver on the FICA timing rules for nonqualified deferred compensation

No doubt familiar to benefits and tax professionals are the Social Security/Medicare (FICA) timing rules that apply to nonqualified deferred compensation (NQDC). In a nutshell, under the special timing rule, NQDC is subject to FICA at the later of when the services are performed or when there is no longer a risk of forfeiture (i.e., vesting). If the employer fails to subject the NQDC to FICA tax at the time of vesting, and the Form 941 statute of limitations is closed for making a correction, the employer is subject to the general-timing rule and is required to withhold FICA tax (including Social Security up to the annual limit) on each future NQDC distribution and any earnings thereon, such as interest. (*IRC §31.3121(v)(2)-1(d)(1)(ii)*.) [1]

Use of the general timing rule can result in additional FICA taxes for employers and their employees. For this reason, business may ask that, pursuant to a voluntary disclosure agreement with the IRS, the special-timing rule be allowed despite the lapse in the statute of limitations for making FICA corrections.

In a 2017 Chief Counsel Memorandum, the IRS concludes that as a policy matter, regulations exist which govern and contain methods for the correction of NQDC reporting failures; therefore, it is not appropriate to enter into a closing agreement in situations where employers did not timely take NQDC into account for purposes of FICA for taxable years which are statutorily barred from assessment. In other words, if the special timing rule is not applied within the statute of limitations for making corrections, use of the general timing rule will be required, without exception. (*IRS Chief Counsel Memorandum AM2017-001, 1-13-2017*.)

This is not the first time the IRS has signaled it will not entertain requests for closing agreements that allow employers to bypass the general timing rule for FICA taxes. In 2010, the IRS similarly held that it should not enter into voluntary disclosure agreements that allow for the use of the special timing rule after the statute of limitations for corrections are passed. (CCA 201025053, 3-10-2017.)

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Employers all too frequently encounter situations where they have not properly paid and withheld FICA tax at the time of vesting. If this error is not detected before the statute of limitations for corrections lapses, employers face not only the potential of higher FICA taxes under the general timing rule, but also the risk of employee litigation. (*Davidson v. Henkel Corporation, DC MI, 115 AFTR 2d 2015-369, 1/6/15*).

For these reasons, businesses should carefully review plan documents and their payroll tax configuration for earnings and deduction codes, confirming that those related to NQDC are set to properly trigger FICA taxes at the time of vesting. Errors should be promptly corrected within the statute of limitations.

The statute of limitations for making corrections pursuant to 2013 generally ends on April 18, 2017.

[1] Under the so-called non-duplication rule, once a deferred amount is taken into account under the special-timing rule, neither that amount nor the income attributable to that amount will be subject to FICA taxes at the time of distribution. Thus, benefits accrued under a nonqualified deferred compensation arrangement are generally subject to federal income tax and federal income tax withholding at the time actually or constructively paid (typically upon distribution). But they are subject to FICA taxes at that time only to the extent not previously taken into account as FICA wages under the special-timing rule. If FICA tax obligations are properly met under these rules, any subsequent NQDC benefit distributions (including any subsequent earnings thereon) are exempt from FICA tax pursuant to the non- duplication rule. (IRC §3121(v)(2)(B); Treas. Reg. §31.3121(v) (2)-1(a)(2)(iii).)